Section 15

K-1 Matching

Partnerships and S-Corporations are collectively known as flow-through entities because they have the legal capacity to pass income and deductions through to their partners or shareholders. Partnerships and S-Corporations file an information return that reports the enterprise's income and expenses with schedules showing the partners' and shareholders' distributive shares of income. The partners and shareholders are then responsible for reporting those items on their individual income tax returns. Flow-through entities are required to provide each partner or shareholder with a Schedule K-1 stating their distributive share of net income or loss to be reported. These K-1s are the Service's link between flow-through entities and the partners and shareholders.

Trusts and estates also have a capacity to flow-through income and deductions to beneficiaries. Unlike Partnerships and S-Corporations, trusts may also pay tax or may be required to collapse all income back to the grantor of the trust, who then is responsible for the tax. Whether the grantor, the trust, or the beneficiary is responsible for reporting income is dependant on powers granted in the trust instrument, decisions made by the trustee, and how Subchapter J of the Internal Revenue Code (IRC) interprets those powers and decisions. Like Partnerships and S-Corporations, income required to be reported by the beneficiary or the grantor is reported to them on Schedule K-1.

Schedule K-1 information uses:

- In 2000, Congress funded the Staffing Tax Administration for Balance and Equity (STABLE) Initiative that provided funding for transcription and matching of K-1 information.
- Approximately 18 million K-1s passing through more than $1.1 trillion of income to their beneficiaries, partners, and shareholders were processed for tax year 2000.
- Research, Taxpayer Education, Service Center Compliance, and Field Compliance functions are using Schedule K-1 information collected for tax year 2000 to enhance our mission of providing better tax products and ensuring fair and equitable tax treatment among all groups of taxpayers.

Taxpayers receiving notices:

- Notices issued from the AUR program are issued as proposals.
- Taxpayers should review the discrepancy outlined on the notice.
- If the taxpayer agrees with the proposal they should sign the notice and follow the instructions for responding. Do not file an amended return.

- If the taxpayer does not agree with the proposal, they are encouraged to correspond with the IRS. Consideration is given to all responses and many cases are closed or resolved without additional tax assessments once an adequate explanation of the mismatch is received.
- Notices issued from the nonfiler program initially request a tax return. If no return is received the ASFR program may prepare a substitute return based on available information.
- Taxpayers receiving these notices should review their filing requirements and tax computation as applicable.
- If the taxpayer agrees with the delinquency notice, they should prepare and submit a tax return per the instructions on the notice. If they agree with the substitute for return figures, they should sign and return the notice with any applicable payment.
- If the taxpayer does not believe they are required to file (i.e., income reported elsewhere), they are encouraged to correspond with the IRS. Consideration is given to all explanations received and cases can be resolved prior to the Service assessing the tax.

Common reasons why a mismatch may occur:

- Netting is a major cause of mismatches, including netting of gains and losses, but most of it is due to a combination of netting passive activity loss carryovers, at-risk carryovers, and unreimbursed expenses claimed.
- K-1s are offset for related business expenses (i.e., unreimbursed partnership expenses).
- Carryovers of passive activity losses, at-risk limitations, and basis adjustments reducing reported income.
- Failure to report an item reflected on K-1 due to an oversight or other reason.
- K-1s are not provided in a timely manner causing estimated numbers to be used on Form 1040.

Reporting income:

- Several steps can be taken to ensure that the IRS will be able to match amounts reported on Schedule K-1 and the amounts reflected on an individual return.
- If offsets are taken for items such as related business expenses, at-risk carryovers, or basis adjustments **do not** combine them with current year figures reported on the Schedule K-1 to arrive at a net amount. Instead, report them on a separate line of a Schedule E as outlined in the Instructions to Schedule E.
- If treatment is inconsistent with the partnership, estate, trust or S-corporation, Form 8082 must be filed.

- Any explanation attached to the individual's return for reporting netted amounts, including passive activity loss carryovers, will help IRS in the matching process before notices are issued.
- Electronic filing by flow-through entities ensures accuracy of the data to be matched.

For more information:

- Visit the IRS Web site to obtain additional information:
  - On responding to notices
  - To obtain the following instructions
    - Instructions for Beneficiary Filing Form 1040
    - Partner's Instructions for Schedule K-1 (1065)
    - Shareholder's Instructions for Schedule K-1 (1120S)